

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

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Bill Number: AB 2979

Related Bills: See Prior Analysis

Telephone: 845-7478

Amended Date: June 6, 2002

Attorney: Patrick Kusiak

Sponsor: _____

SUBJECT: Adjust. Of Refundable Credit/Clarify Gov't Code/Electronic Signatures/Frivolous Return Penalty/HRA Technical/Innocent Spouse/ Other State Tax Credit Source Rules

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 27, 2002, STILL APPLIES.

X

X

OTHER - See comments below.

SUMMARY

This Franchise Tax Board (FTB) sponsored bill would:

- Amend the Government Code to delete an obsolete reference.
- Give FTB statutory authority both to accept e-signatures for returns and to prescribe procedures for e-signatures for returns.
- Address an administrative problem in the processing of the Child and Dependent Care Credit.
- Conform state law to federal law regarding certain penalties.
- Make nonsubstantive, technical changes to the Senior Citizens Homeowners and Renters Property Tax Assistance Laws.
- Provide specific sourcing rules for the other state tax credit.
- Increase the gross income and state income tax liabilities that would qualify for judicial relief of joint and several tax liabilities.
- Inform the parties to a divorce proceeding of existing tax laws regarding divorce court orders.

Board Position:

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____ PENDING

Legislative Director

Date

Brian Putler

6/11/02

SUMMARY OF AMENDMENTS

The June 6, 2002, amendments would provide specific sourcing rules for the other state tax credit. In addition, the amendments would make the following changes regarding relief of joint and several tax liability:

- increasing the qualifying gross income and state income tax liability thresholds, and
- informing the parties to a divorce proceeding of existing tax laws regarding divorce court orders.

Each of these provisions will be discussed separately.

The remainder of the department's analysis of the bill as introduced February 27, 2002, still applies.

POSITION

Support.

At its March 6, 2002, meeting, the Franchise Tax Board voted to sponsor the language in this legislation.

OTHER STATE TAX CREDIT SOURCE RULES

PURPOSE OF THE BILL

This provision would codify the detailed rules regarding sourcing of out of state income that are presently in both case law and regulations.

EFFECTIVE/OPERATIVE DATE

This provision, as a tax levy, would be effective immediately and would be operative for taxable years beginning on or after January 1, 2002.

ANALYSIS

FEDERAL/STATE LAW

There is no federal credit comparable to the other state tax credit discussed in this provision.

Existing state law imposes tax on the income earned by individuals, partnerships, estates, and trusts. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

Existing California law allows a tax credit for net income taxes paid to a state other than California. The credit is based on taxes paid to the other state on income that is also taxable under California law. The income must be from sources within the other state.

California regulations and case law are used to determine the source of income, regardless of any provision or interpretation of the law of the other state.

State law also provides specific rules to determine the source of income for California gross income for nonresident taxpayers. For nonresident taxpayers, California gross income includes only gross income derived from sources within this state.

THIS BILL

This provision would codify the nonresident sourcing rules for determining the appropriate other state tax credit that are presently found in case law and regulations.

LEGISLATIVE HISTORY

SB 1229 (Senate Revenue and Taxation Committee, Stats. 1999, Ch. 987) made several changes to the state's income tax laws, including technical changes, filing date changes, and other income tax related items. An earlier version of SB 1229 included a provision similar to the other state tax credit sourcing rule provision proposed by this bill.

OTHER STATES' INFORMATION

The income tax laws of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were reviewed because of their similarities to California's income tax laws.

Illinois allows a credit equal to the lesser of the tax on items of income included in both states, or the amount of the Illinois tax multiplied by the gross income taxable in the other state divided by the total gross income for Illinois.

Massachusetts allows a credit equal to the lesser of tax due to the other state reduced by interest, penalties, and any federal credit allowable on the federal return, or the amount of the Massachusetts tax multiplied by the gross income taxable in the other state divided by the total gross income for Massachusetts.

New York allows a credit for taxes paid to other states. The credit cannot reduce the tax below the amount of tax that would have been due had the income from the other state not been included.

Michigan and *Minnesota* do not have a credit similar to California's other-state-tax credit.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Any revenue impact associated with this provision would be insignificant. The provision is declaratory of case law and departmental policy.

ARGUMENTS/POLICY CONCERNS

This provision would provide certainty for both the taxpayer and the department in administering the other state tax credit. Also, it would provide effective guidance for taxpayers with complex sourcing issues.

Case law and regulations currently implicate the use of nonresident sourcing rules in determining the credit. This bill would affirm such use and would provide, without question, that the nonresident sourcing rules shall be used in determining the other state tax credit.

RELIEF OF JOINT AND SEVERAL TAX LIABILITIES

PURPOSE OF THE BILL

The purpose of this provision is to allow more taxpayers to qualify for judicial relief of joint and several tax liabilities.

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2003, and operative for divorce court orders issued after that date.

PROGRAM BACKGROUND

Under federal and state income tax law, spouses who file a joint tax return are each responsible for the accuracy of the return and for the full tax liability for that tax year. These obligations apply regardless of which spouse earns the income. The concept of obligating each spouse separately for all of the tax liability is called joint and several liability. Joint and several liability can result in inequitable consequences to one spouse in certain circumstances. Consequently, the federal government and California enacted "innocent spouse" legislation, which may allow a spouse to be relieved of some or all of the responsibility of a joint tax debt.

ANALYSIS

FEDERAL/STATE LAW

The federal Internal Revenue Service Restructuring and Reform Act of 1998 made innocent spouse relief easier to obtain. The Act allows an innocent spouse to qualify for relief under one of the following provisions:

1. *Understatement/Apportionment.* To qualify for relief the taxpayer must show that the understatement of tax is a result of an erroneous item. In addition, the taxpayer must show that at the time the return was signed he or she did not know and had no reason to know of the understatement of tax. Another option allows the requesting spouse to show partial liability. To qualify for relief from the liability that is attributed to the portion of the understatement of income, the taxpayer must show the same lack of knowledge, as described above, when the return was signed.

2. *Separate liability election.* A requesting spouse may elect to be taxed as though he or she filed a *married filing separate* tax return. Any liability for understatement of tax, interest, and penalties will be limited to the amount attributable to the income the individual spouse actually earned. This relief is available to taxpayers who are no longer married, are legally separated, or have lived apart from their spouse for 12 months prior to requesting relief. At the time the joint return was signed, the requesting spouse must have lacked actual knowledge of the item resulting in the tax deficiency.
3. *Equitable relief.* The Internal Revenue Service (IRS) determines from a review of all the facts and circumstances that the requesting taxpayer would not qualify for relief under either 1 or 2 above and it would not be equitable to hold the requesting spouse liable for any unpaid tax or any deficiency.

In 1999 California conformed to portions of the 1998 federal Act by enacting the Taxpayer Bill of Rights Act of 1999, which revised and expanded innocent spouse relief at the state level. Under California law, disputes involving innocent spouse issues are heard by the Board of Equalization.

A taxpayer requesting innocent spouse relief in California has the right to a determination based on the facts presented to the department, regardless of any relief or denial of relief by the IRS.

California law allows two avenues for relief that are not available under federal law.

1. *Relief from Self-Assessed or Deficiency Tax Amounts by Court Order.* A taxpayer may seek a divorce court order relieving the taxpayer of joint and several liability for state income tax on a joint return as well as state income tax resulting from an audit. The order cannot relieve tax on any income that was earned by or derived from assets under the exclusive control and management of the taxpayer seeking relief. The gross income reported on the return must not exceed \$50,000 and the tax liability must not exceed \$2,500. The court order must state the tax years involved and can revise only unpaid tax amounts.

In those instances where either the gross income or the tax liability exceeds the thresholds for relief, and the taxpayer wants judicial relief, the taxpayer must obtain and file with the court an FTB Tax Revision Clearance Certificate. The Certificate states the income tax years and amounts of any unpaid tax liabilities of the parties involved in the divorce. The court then incorporates the Certificate as part of the court order of dissolution of marriage and serves the order on FTB. If the taxpayer fails to provide the court with the Certificate prior to the dissolution of the marriage, the taxpayer may later request the court to reopen the divorce proceeding to provide the tax relief.

2. *Relief from Self-Assessed Tax Amounts.* A taxpayer may seek relief from the department on any unpaid self-assessed tax liability on a joint return, including penalties and interest. The tax liability must not be attributable to income that was under the exclusive control and management of the taxpayer seeking relief. State law requires the taxpayer to demonstrate that he or she did not know and had no reason to know of the nonpayment of tax at the time the return was filed.

Currently, the Family Code contains the various laws regarding division of property and debts during the dissolution of a marriage.

THIS BILL

This provision would:

- increase the gross income and tax liability thresholds to qualify for relief under a divorce court order to reflect inflation from 1977 to 2001. Therefore, the amounts would become \$150,000 for the gross income threshold and \$7,500 for the state income tax liability threshold.
- specify that the court order must address personal California income tax liabilities.
- add language to the Family Code informing the parties to a divorce proceeding that current income tax laws exist regarding divorce court orders and make specific reference to the provision allowing taxpayers to seek relief from joint and several liability.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision is not anticipated to significantly impact the department's programs and operations and would improve the department's ability to administer laws relating to the innocent spouse program.

OTHER STATES' INFORMATION

A review of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* income tax laws found that all of these states offer some type of innocent spouse relief. It appears that none of the states offer relief that is similar to the judicial relief already offered by California. The *Minnesota* Department of Revenue website states that it does not honor the assignment of tax liabilities in divorce decrees.

The laws of these states were reviewed because their income tax laws are similar to California's income tax laws.

FISCAL IMPACT

No departmental costs are associated with this provision. The department anticipates an increase in the receipt of court orders, but the increase in the thresholds would allow more taxpayers to qualify for judicial relief, which is a much less complex workload than the procedures to determine innocent spouse status. Since judicial relief and innocent spouse relief are administered within the same section of the department, it is anticipated that resources within that section could be shifted to accommodate any possible workload changes.

ECONOMIC IMPACT

Although this provision would allow additional taxpayers to qualify for judicial relief of joint and several tax liabilities, it would have no impact on state income tax revenue. The effects of this provision would not change taxpayer liabilities, but instead divide the existing liabilities between the individuals involved in the divorce.

ARGUMENTS/POLICY CONCERNS

The department estimates that judicial relief is denied to 95% of taxpayers under current income tax law. The low gross income and tax liability thresholds account for 70% of the denials. Further, the department estimates that only a handful of those taxpayers have gone the extra step and requested a Tax Revision Clearance Certificate in the last year. Under this bill, it is estimated that relief would be granted to 80% of the taxpayers requesting relief.

The remaining 30% of the taxpayers are denied judicial relief because their court order does not meet the specified criteria under the income tax law. Clarifying the income tax law and adding a section to the Family Code informing individuals, practitioners, and courts of these tax laws would increase awareness of what constitutes a court order that is binding on FTB. Taxpayers and the family law community may be encouraged to address their unpaid state tax liabilities during the divorce proceeding.

This provision would allow more taxpayers to qualify for judicial relief and eliminate their need to file for innocent spouse relief at a future date. In addition, this provision would decrease the number of taxpayers seeking a Tax Revision Clearance Certificate and eventually should decrease the number of spouses required to reopen their divorce case to obtain relief.

The department's collection efforts may be enhanced because it could concentrate on the spouse liable for the tax debt under the court order.

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